**State of California**

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**Legislative Change No. 98-01**

Bill Number: SB 519 Author: Lockyer Chapter Number: 98-07

Laws Affecting Franchise Tax Board: Sections 17039, 17053.47, 17062, 17088.5, 17088.6, 17132.6, 17207.4, 17276.2, 17559, 17731.5, 17760.5, 18036.5, 18037.3, 18038.5, 18155.5, 18510, 18572, 19023, 19024, 19025, 19109, 19136.3, 19147, 19149, 19184, 19280, 19365, 23036, 23456, 23622.8, 23800.5, 23802, 23813, 24347.4, 24416.2, 24652.5, 24661.5, 24871.5, 24872.4, 24872.5, 24872.7, 24875.5, 24918, 24949.1, 24954, of the Revenue and Taxation Code Sections, to amend Sections 110 and 112 of AB 1040 (Stats. 1997, Ch. 605), to amend Section 30 of SB 455 (Stats. 1997, Ch. 611), and to add Section 19 to SB 200 (Stats. 1997, Ch. 609):

Date Filed with the Secretary of the State: March 14, 1998

SUBJECT:

Conformity to Certain Provisions of the Federal Taxpayer Relief Act of 1997 and 1997 Tax Law Clean-Up.

**Senate Bill 519 (Lockyer), as enacted on February 13, 1998, made the following changes to California law:**

**Amend Section 17039 of Revenue and Taxation Code** to reinstate portions of AB 1217 (Stats. 1997, Ch. 602) that were chaptered out by SB 1106 (Stats. 1997, Ch. 604) and SB 1234 (Stats. 1997, Ch. 608). The amendments made to Sections 17039 and 23036 reinstate targeted tax area credits to the list of credits that can reduce regular tax below tentative minimum tax for taxable or income years beginning on or after January 1, 1998.

**Amend Section 17053.47 of Revenue and Taxation Code** to allow a taxpayer only one credit if wages paid qualify for the wage credit for the Manufacturing Enhancement Area and another credit. Prior to this Act the taxpayer “elected” one credit.

**Amend Section 17062 of Revenue and Taxation Code** to reinstate changes made by SB 1106 and SB 455 that were chaptered out by SB 1233 (Stats. 1997, Ch. 612).

The provision that added subparagraphs (B), (C) and (D) of paragraph (4) of Section 17062 reinstates the definitions of “aggregate gross receipts, less returns and allowances,” “gross receipts less returns and allowances” and “proportionate interest.” These items were enacted for 1997 by SB 1106 and SB 455 to clarify the definition of “qualified taxpayer” that was enacted by SB 38 (Stats. 1996, Ch. 954). SB 1233 “chaptered out” the definitions beginning in 1998. Therefore, this provision reinstates the definitions for taxable and income years beginning on or after January 1, 1998.

The provision that paragraph (3) of subdivision (c) of Section 17062 reinstates the adjustment item for the difference between the stock’s fair market value when it was purchased and the option price for California Qualified Stock Options. This

Bureau Director: Johnnie Lou Rosas | Date: April 16, 1998 provision was originally enacted by AB 3194 (Stats. 1996, Ch. 951) but was "chaptered out" by SB 38. SB 1106 and SB 455 re-enacted the provisions for 1997, but SB 1233 chaptered it out for 1998.

The amendments to Section 17062 also corrected errors in Section 17062 relating to married filing separate exemption and phase-out amounts in the alternative minimum tax (AMT) provisions. SB 1233 added these amounts to Section 17062 based on the amounts published in the department's Alternative Minimum Tax Report. However, the Alternative Minimum Tax Report contained typographical errors. The married filing separate exemption amount should be $28,630 and the phase-out amount should be $107,362 instead of $28,360 and $117,362, respectively. Married filing separate amounts are normally one-half of married filing joint amounts.

Additionally, the amendments repealed the alternative minimum tax (AMT) installment method adjustment for farmers. The installment method allows gain on the sale of property to be recognized as payments are received. Under the regular tax, dealers in personal property are not allowed to defer the recognition of income by use of the installment method on the installment sale of such property. For this purpose, dealer dispositions do not include sales of any property used or produced in the trade or business of farming. For AMT purposes, the installment method is not available with respect to the disposition of any property that is the stock in trade of the taxpayer or any other property of a kind which would be properly included in the inventory of the taxpayer if held at year end, or property held by the taxpayer primarily for sale to customers.

Under federal law, prior to the enactment of the Tax Relief Act (TRA) of 1997 (P.L. 105-34), no explicit exception was provided for installment sales of farm property under AMT. The TRA of 1997 generally provided that for purposes of the AMT, farmers may use the installment method of accounting. Therefore, a farmer using the installment method will not have an adjustment for AMT purposes. The federal change generally is effective for dispositions in taxable years beginning after December 31, 1987, with a special rule for dispositions occurring in 1987.

This provision conformed California law to federal law as it relates to the use of the installment method by farmers under AMT. Under California law, payments received in taxable or income years beginning on or after January 1, 1997, for installment sales made in taxable or income years beginning after December 31, 1987, would not have an AMT adjustment.

**Add Section 17088.5 of Revenue and Taxation Code** relating to the repeal of 30% gross income test for "regulated investment companies" (RICs). Under prior law, to qualify as a RIC, a company must derive less than 30% of its gross income from the sale or other disposition of certain investments (including stock, securities, options and forward contracts) held for less than three months (the "30% test" or "short-short rule").

The TRA of 1997 repealed the 30% test (or short-short rule). The provision is repealed effective for taxable years beginning after August 5, 1997.

This provision repealed the 30% test for California purposes with the same effective date as federal.

**Add Section 17088.6 of Revenue and Taxation Code** to repeal the 30% gross income test of real estate investment trusts (REITs). The TRA of 1997 repealed the rule that requires less than 30% of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than one year, certain real property held less than four years, and property that is sold or disposed of in a prohibited transaction. This provision conforms to the federal repeal of the 30% gross income test.

This Act also clarified shared appreciation and added a bankruptcy safe harbor for REITs. The TRA of 1997 provides that interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within four years of the REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor unless, when the REIT acquired the mortgage, and the REIT knew, or had reason to know, that the property subject to the mortgage would be sold in a bankruptcy proceeding.

This provision conforms California law to federal law regarding shared appreciation and the bankruptcy safe harbor discussed above.

**Add Section 17132.6 of Revenue and Taxation Code** to provide an exclusion from income of survivor benefits of public safety officers killed in the line of duty. Under present federal and California law, survivors of military service personnel (such as those killed in combat) are generally entitled to survivor benefits. These survivor benefits are generally exempt from taxation. "Survivor" means the surviving spouse or surviving dependent child of the military service personnel.

Under federal law, the TRA of 1997 generally provided that an amount paid as a survivor annuity on account of the death of a public safety officer who is killed in the line of duty is excludable from income to the extent the survivor annuity is attributable to the officer's service as a law enforcement officer. The survivor annuity must be provided under a governmental plan to the surviving spouse (or former spouse) of the public safety officer or to a child of the officer. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. The exclusion does not apply with respect to the death of a public safety officer if it is determined by the appropriate supervising authority that (1) the death was caused by the intentional misconduct of the officer or by the officer's intention to bring about the death, (2) the officer was voluntarily intoxicated at the time of death, (3) the officer was performing his or her duties in a grossly negligent manner at the time of death, or (4) the actions of the individual to whom payment is to be made were a substantial contributing factor to the death of the officer. The exclusion applies to amounts received in taxable years beginning after December 31, 1996, with respect to individuals dying after that date.

California law is conformed to the federal provisions as of January 1, 1997, relating to survivor benefits and disability payments. Under California law, survivor annuity benefits paid under a governmental retirement plan to a survivor of a law enforcement officer killed in the line of duty are generally includible in income except to the extent the benefits are a return of after-tax employee contributions. Under present and prior law, survivor benefits paid under a government plan only to survivors of officers who died as a result of injuries sustained in the line of duty are in the nature of workers' compensation and are generally excludable from income.

This provision conforms California law to federal law as it relates to the taxability of survivor benefits of public safety officers with the same effective date.

**Add Section 17207.4 & 24347.6 of Revenue and Taxation Code** to accept certain appraisals to establish the amount of a disaster loss.

Under existing federal law and state tax law, a taxpayer may claim a loss from a disaster in an area determined by the President of the United States to warrant federal assistance. The taxpayer may elect either to claim the disaster loss in the year the loss occurs or in the year preceding the loss. This election allows the taxpayer to immediately file an amended return for the prior year. For state purposes, this election may be made prior to passage of any state legislation allowing special carryback treatment because California conforms to the federal election.

As with casualty losses, nonbusiness disaster losses not reimbursed by insurance are deductible under state and federal tax law to the extent each loss exceeds $100, and total nonbusiness disaster losses are deductible only to the extent that the total loss amount for the year exceeds 10% of adjusted gross income.

To claim a disaster loss, a taxpayer must establish the amount of the loss. This may, for example, be done through the use of an appraisal.

Under federal law, the TRA of 1997 provides that nothing in the Internal Revenue Code should be construed to prohibit the Treasury from issuing guidance providing that an appraisal for the purpose of obtaining a federal loan or federal loan guarantee as the result of a Presidentially-declared disaster may be used to establish the amount of a disaster loss. This federal provision applies August 5, 1997.

This provision conforms state law to federal law as it relates to the use of appraisals prepared for federal disaster relief for establishing the amount of a disaster loss with the same effective date.

**Amend Section 17276.2 of Revenue and Taxation Code** to reinstate portions of AB 1217 (Stats. 1997, Ch. 602) that were chaptered out by SB 1106 (Stats. 1997, Ch. 604) and SB 1234 (Stats. 1997, Ch. 608). The amendments made to Sections 17276.2 and 24416.2 reinstate the targeted tax area net operating loss provisions for taxable or income years beginning on or after January 1, 1998.

**Add Sections 17559 and 24661.5 of Revenue and Taxation Code** to conform to the federal treatment of livestock sold on account of weather-related conditions.

Under federal and state law, in general, cash-method taxpayers report income in the year it actually is received or is constructively received. However, the law contains two special rules applicable to livestock sold because of drought conditions. A cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for federal assistance. This exception is generally intended to put taxpayers that receive an unusually high amount of income in one year in the position they would have been in the absence of the drought. The other special rule is discussed under Section 18037.3 below.

The TRA of 1997 expanded the special treatment for sale of livestock on account of drought to livestock sold on account of floods and other weather related conditions. The expansion of the treatment applies to sales and exchanges on or after January 1, 1997.

This provision modifies Section 451(e) of the Internal Revenue Code and conforms California law to federal law as it relates to the expansion the special treatment as discussed above for sale of livestock on account of drought to livestock sold on account of floods and other weather-related conditions with the same effective date.

**Repeal Section 17731.5 of Revenue and Taxation Code** duplicate sections enacted by both SB 5 (Stats. 1997, Ch. 610), in stand-alone language, and SB 455 (Stats. 1997, Ch. 611), in date change language.

**Add Section 17760.5 of Revenue and Taxation Code** for simplified taxation of earnings of pre-need funeral trusts.

A pre-need funeral trust is an arrangement where an individual purchases funeral services or merchandise from a funeral home for the benefit of a specified person in advance of that person's death. (The beneficiary may be either the purchaser or another person.) The purchaser enters into a contract with the provider of such services or merchandise whereby the purchaser selects the services or merchandise to be provided upon the death of the beneficiary, and agrees to pay for them in advance of the beneficiary's death. Such amounts (or a portion thereof) are held in trust during the beneficiary's lifetime and are paid to the seller upon the beneficiary's death.

Under federal law, the TRA of 1997 allows the trustee of a pre-need funeral trust to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. A qualified funeral trust is defined as one which meets the following requirements: (1) the trust arises as the result of a contract with a person engaged in the trade or business of providing funeral or burial services or merchandise; (2) the only beneficiaries of the trust are individuals with respect to whom such services or merchandise are to be provided at their death; (3) the only contributions to the trust are contributions by or for the benefit of the trust beneficiaries; (4) the trust's only purpose is to hold and invest funds that will be used to make payments for funeral or burial services or merchandise for the trust beneficiaries; and (5) the trust has not accepted contributions totaling more than $7,000 by or for the benefit of any individual. For this purpose, "contributions" include all amounts transferred to the trust, regardless of how denominated in the contract. Contributions do not, however, include income or gain earned with respect to property in the trust. For purposes of applying the $7,000 limit, if a purchaser has more than one contract with a single trustee (or related trustees), all such trusts are treated as one trust. Similarly, if the Secretary of the Treasury determines that a purchaser has entered into separate contracts with unrelated trustees to avoid the $7,000 limit described above, the Secretary may require that such trusts be treated as one trust. For contracts entered into after 1998, the $7,000 limit is indexed annually for inflation.

Under federal law, the trustee's election to have this provision apply to a qualified funeral trust is to be made separately with respect to each purchaser's trust. It is anticipated that the Department of the Treasury will issue prompt guidance with respect to the simplified reporting requirements so that if the election is made, a single annual trust return may be filed by the trustee, separately listing the amount of income earned with respect to each purchaser. If the election is made, the trust is not treated as a grantor trust and the amount of tax paid with respect to each purchaser's trust is determined in accordance with the income tax rate schedule generally applicable to estates and trusts, but no deduction for a personal exemption is allowed. The tax on the annual earnings of the trust is payable by the trustee. The provision is effective for taxable years ending after August 5, 1997.

This provision conforms California law to the changes made by the TRA of 1997 to pre-need funeral trusts with the same effective date.

**Add Sections 18036.5, 18038.5 and 18155.5 of Revenue and Taxation Code** to allow for the rollover of gain from small business stock.

The Revenue Reconciliation Act of 1993 provided individuals a 50% exclusion for the sale of certain small business stock acquired at original issuance and held for at least five years. One-half of the excluded gain is a minimum tax preference item. The amount of gain eligible for the 50% exclusion by an individual with respect to any corporation is the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet an active trade or business requirement.

Prior to the enactment of SB 519, California law conformed to the federal exclusion of 50% of the gain from the sale of small business stock with modifications. In addition to the federal requirements, for California purposes the corporation must be doing business in California throughout the five year period and 80% of its payroll must be attributable to employment located in California. California has not conformed to the rollover provision.

New federal law allows an individual to rollover gain from the sale or exchange of qualified small business stock held more than six months where the taxpayer uses the proceeds to purchase other qualified small business stock within 60 days of the sale. For purposes of the rollover provision, the replacement stock must meet the active business requirement for the six-month period following the purchase. Generally, the holding period of the replacement stock will include the holding period of the stock sold, except for purposes of determining whether the replacement stock was held for the required six-month holding period is met. The new law applies to sales after August 5, 1997.

This provision conforms California law with the federal law small business stock rollover provisions only with respect to the rollover of qualified California small business stock using the same effective date.

**Add Sections 18037.3 and 24949.1 of Revenue and Taxation Code** to conform to the federal treatment of livestock sold on account of weather-related conditions.

Under federal and state law, in general, cash-method taxpayers report income in the year it actually is received or is constructively received. However, the law contains two special rules applicable to livestock sold because of drought conditions (see Section 17559 above for exception 1). The sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under IRC section 1033(e). Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

The TRA of 1997 expanded the special treatment for sale of livestock on account of drought to livestock sold on account of floods and other weather related conditions. The expansion of the treatment applies to sales and exchanges on or after January 1, 1997.

This provision conforms California law to federal law and expand the involuntary conversion treatment for sale of livestock on account of drought to livestock sold on account of floods and other weather-related conditions with the same effective date.

**Amend Section 18510 of Revenue and Taxation Code** to reinstate a provision of SB 5 chaptered out by SB 1233. This provision reinstates the filing requirement for taxpayers whose only income is from the excludible gain on the sale of a personal residence for 1997. This requirement is in the law for 1998.

**Add Section 18572 of Revenue and Taxation Code** to conform California law to federal law as it relates to the postponement of certain tax-related deadlines.

Federal law provides that in the case of a taxpayer determined to be affected by a Presidentially-declared disaster, the Secretary of the Treasury may specify that, for a period of up to 90 days, certain taxpayer deadlines (including, but not limited to, filing a return) are postponed. The deadlines that may be postponed are the same as those postponed by reason of service in a combat zone. The provision does not apply for purposes of determining interest on any overpayment or underpayment. This provision applies to any period for performing an act that did not expire before August 5, 1997.

Prior to the passage of this Act, California law provided that the Franchise Tax Board may grant an extension up to six months to file a return. California law also is conformed to the statute which provides postponement of certain tax-related deadlines by reason of service in combat zones.

This provision conforms California law to federal law as it relates to the postponement of certain tax-related deadlines due to a Presidentially-declared disaster with the same effective date, with a substitution of the “Franchise Tax Board’ for the “Secretary of the Treasury”.

**Amend Sections 19023, 19024, 19025, 19147, 19149 of Revenue and Taxation Code** to direct qualified subchapter S subsidiary tax to be subject to estimated tax payments.

Under federal and state law, effective for income years beginning on or after January 1, 1997, S corporations are allowed to own subsidiaries. The S corporation cannot file a consolidated return for federal purposes or a combined report for state purposes with its subsidiary. However, if the S corporation owns 100% of the subsidiary, the S corporation may elect to treat the subsidiary as a "qualified subchapter S subsidiary" (QSSS). A QSSS is not treated as a separate corporation for tax purposes and all the assets, liabilities and items of income, deduction and credit treated as the assets, liabilities and items of income, deduction and credit of the (parent) S corporation.

Under California law, a QSSS is subject to a $800 tax assessed annually. The annual tax is assessed on the QSSS but is also the liability of the S corporation. The annual tax is due and payable on the 15th day of the fourth month of the S corporation's income year, the same day the S corporation's first estimated tax payment installment is due. The QSSS annual tax is subject to the failure to pay tax (by due date) penalty and interest. However, the QSSS is not required to file a return. Consequently, the FTB would be unable to determine if an S corporation should have paid the QSSS annual tax on the 15th day of the fourth month of its income year until the S corporation filed its tax return (possibly as late as 18 months later).

Additionally, prior to the passage of this Act, California law did not address the possibility of a S corporation acquiring an QSSS after the 15th day of the fourth month of the S corporation's income year.

This provision modifies the QSSS tax to make it due and payable (and subject to the same kinds of penalties) as the minimum tax of the S corporation, with modifications to reflect that there could be more than one QSSS tax owed by a single S corporation owner and that the election for QSSS treatment can occur at any time during the year. Basically, the provision makes the QSSS tax due when the S corporation's tax return is due, but the tax is subject to the estimated tax rules and is payable when the first estimated tax payment of the S corporation is due. If the QSSS was acquired during the income year, the QSSS tax is due with the first estimated tax payment of the S corporation after the date of the QSSS election.

**Add Section 19109 of Revenue and Taxation Code** to abate interest on underpayments by taxpayers in Presidentially-declared disaster areas.

Under federal law, the Secretary of the Treasury is required to abate interest for the same period of time for which the Secretary of the Treasury has provided an extension of time to file tax returns and pay taxes (and waives any penalty)(Section 18572 above) for individuals located in Presidentially-declared disaster areas. The federal provision applies only to disasters declared during 1997.

This provision requires the FTB to abate interest for individual taxpayers located in a Presidentially-declared disaster area for the period the FTB extended the time to file a return and pay the tax (and waive any penalty) for disasters declared during 1997.

**Amend Section 19136.3 of Revenue and Taxation Code** to waive the estimated tax penalty.

This provision waives additions to tax imposed for any underpayments of tax or estimated tax for any period before April 15, 1998, with respect to any underpayment for the 1997 or 1998 taxable or income year to the extent the underpayment was created or increased by any provision of this Act.

**Amend Section 19184 of Revenue and Taxation Code** to reinstate a provision of SB 455 chaptered out by SB 1233. This provision reinstates the penalty for failure to file medical savings account (MSA) reports for 1997. This penalty is in the law for 1998 prior to the passage of this Act.

**Amend Section 19280 of Revenue and Taxation Code** to correct an incorrect reference. The reference in Section 19280 to Section 18401 is changed to a reference to Section 17001.

**Repeal Section 19365 of Revenue and Taxation Code,** duplicate sections enacted by both SB 5 (Stats. 1997, Ch. 610), in stand-alone language, and SB 455, in date change language.

**Amend Section 23036 of Revenue and Taxation Code** to reinstate portions of AB 1217 (Stats. 1997, Ch. 602) that were chaptered out by SB 1106 (Stats. 1997, Ch. 604) and SB 1234 (Stats. 1997, Ch. 608). The amendments to Sections 17039 and 23036 reinstate targeted tax area credits to the list of credits that can reduce regular tax below tentative minimum tax for taxable or income years beginning on or after January 1, 1998.

**Amend section 23456 of Revenue and Taxation Code** to conform California law to federal law as it relates to the use of the installment method by farmers under AMT (see Section 17062 for background). Under California law, this provision provides that payments received in taxable or income years beginning on or after January 1, 1997 for installment sales made in taxable or income years beginning after December, 1987 would not have an AMT adjustment.

**Amend Section 23622.8 of Revenue and Taxation Code** to allow a taxpayer only one credit if wages paid qualify for the wage credit for the Manufacturing Enhancement Area and another credit. Prior to this Act the taxpayer “elected” one credit.

Additionally, this provision removes an AMT exemption for merchant marine capital construction accounts inadvertently not removed by SB 455, which conformed California law to the federal treatment of merchant marine capital construction accounts.

**Repeal Section 23800.5, as added by SB 5, of Revenue and Taxation Code,** duplicate sections enacted by both SB 5, in stand-alone language, and SB 455, in date change language.

**Amend Section 23800.5, as added by SB 455, of Revenue and Taxation Code** to remove the provision requiring the tax assessed annually on QSSS to be due and payable the 15th day of the fourth month of the income year of the S corporation. The tax assessed annually on a QSSS was made subject to estimated tax by this Act (Section 19023, et al, above).

**Repeal Sections 23802, 23813 and 24954 of Revenue and Taxation Code,** duplicate sections enacted by both SB 5 (Stats. 1997, Ch. 610), in stand-alone language, and SB 455, in date change language.

**Amend Section 24416.2 of Revenue and Taxation Code** to reinstate portions of AB 1217 (Stats. 1997, Ch. 602) that were chaptered out by SB 1106 (Stats. 1997, Ch. 604) and SB 1234 (Stats. 1997, Ch. 608). The amendments to Sections 17276.2 and 24416.2 reinstate the targeted tax area net operating loss provisions for taxable or income years beginning on or after January 1, 1998.

**Amend Section 24652.5 of Revenue and Taxation Code** to eliminate suspense accounts for family farming corporations.

The TRA of 1997 repealed the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the TRA of 1997, any family farm corporation required to change to an accrual method of accounting will restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change.

Additionally, under federal law, any taxpayer with an existing suspense account is required to restore the account into income ratably over a 20-year period beginning in the first taxable year beginning after June 8, 1997, subject to the requirements (ceased to be a family corporation) to restore such accounts more rapidly. The TRA of 1997 repealed the requirement to accelerate the recovery of suspense accounts when the gross receipts of the taxpayer decreases.

The amount required to be restored to income for a taxable year pursuant to the 20-year spread period shall not exceed the net operating loss of the corporation for the year (in the case of a corporation with a net operating loss) or 50% of the net income of the taxpayer for the year (for corporations with taxable income). For this purpose, a net operating loss or taxable income is determined without regard to the amount restored to income under the provision. Any reduction in the amount required to be restored to income is taken into account ratably over the remaining years in the 20-year period or, if applicable, after the end of the 20-year period. Amounts that extend beyond the 20-year period remain subject to the net operating loss and 50%-of-taxable income rules. The net operating loss and 50%-of-taxable income rules do not apply to restorations of suspense accounts pursuant to present law.

Federal law also clarifies that in the case of a family farm corporation that elects to be an S corporation for a taxable year, the net operating loss and 50% of taxable income limitations shall be determined by taking into account all the items of income, gain, deduction and loss of the corporation, regardless of whether such items are separately stated under Internal Revenue Code (IRC) section 1366.

This provision conforms California law to federal law as it relates to use of the accrual method of accounting, family farming corporations and the elimination of suspense accounts for income years beginning on or after June 9, 1997.

**Amend section 24871.5 of Revenue and Taxation Code** to repeal the 30% gross income test for regulated investment companies (RICs).

To qualify as a RIC, prior to the enactment of the TRA of 1997, a company must derive less than 30% of its gross income from the sale or other disposition of certain investments (including stock, securities, options and forward contracts) held for less than three months (the “30% test” or “short-short rule”).

Under federal law the TRA of 1997 repealed the 30% test (or short-short rule). The provision is repealed effective for taxable years beginning after August 5, 1997.

This provision repeals the 30% test for California purposes with the same effective date as federal.

**Add Sections 24872.4, 24872.5, and 24872.7 of Revenue and Taxation Code** to modify the rules for real estate investment trusts (REITs).

The TRA of 1997 made modifications to federal law relating to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions. The changes are effective for taxable years beginning after August 5, 1997.

Clarification of Limitation on Maximum Number of Shareholders and Penalties for Failure to Determine Ownership - The TRA of 1997 replaces the rule that disqualifies a REIT for any year in which the REIT failed to comply with Treasury regulations to ascertain its ownership with an intermediate penalty for failing to do so. The penalty is $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also is required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the Treasury regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, is treated as meeting the requirement that it not be a personal holding company.

De Minimis Rule for Tenant Services Income - The TRA of 1997 permits a REIT to render a de minimis amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services may not exceed 1% of the gross income from the property. For these purposes, the services may not be valued at less than 150% of the REIT's direct cost of the services.

25% Attribution for Partners - The TRA of 1997 modified the application of the rule attributing ownership from partners to partnerships for purposes of defining non-qualifying rent from related persons, so that attribution occurs only when a partner owns, directly or indirectly, a 25% or greater interest in the partnership. Thus, a REIT and a tenant will not be treated as related (and, therefore, rents paid by the tenant to the REIT will not be treated as non-qualifying rents) if the REIT's shares are owned by a partnership and a partner owning, directly or indirectly, a less-than-25% interest in that partnership also owns an interest in the tenant. The related tenant rule also will not be violated where owners of the REIT and owners of the tenant are partners in a partnership and either the owners of the REIT or the owners of the tenant are, directly or indirectly, less-than-25% partners in the partnership.

In addition, the TRA of 1997 extends, to the definition of an independent contractor, the modification to the attribution to partnerships so that attribution occurs only when a partner owns a 25% or greater interest in the partnership. Thus, a person providing services will not fail to be an independent contractor (and, therefore, amounts received or accrued by the REIT with respect to the property will not be treated as non-qualifying rents) where the REIT's shares are owned by a partnership and a partner owning, directly or indirectly, a less-than-25% interest in the partnership also owns an interest in a contractor. Similarly, a contractor will not fail to be an independent contractor where owners of the REIT and owners of the contractor are partners in a partnership and either the owners of the REIT or owners of the tenant are, directly or indirectly, less-than-25% partners in the partnership.

Credit Retained Capital Gains Tax Paid - The TRA of 1997 permits a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted to do. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would also be deemed to have paid the shareholder's share of the tax paid by the REIT, which would be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

30% Gross Test Repealed - The TRA of 1997 repealed the rule that requires less than 30% of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than one year, certain real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Ordering Rules for Earnings and Profits Distribution - The TRA of 1997 changes the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Distributions of accumulated earnings and profits generally are treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions are not treated as distributions for purposes of calculating the dividends paid deduction.

Grace Period for Foreclosure Property Extended - The TRA of 1997 lengthened the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also could be extended for an additional three years by filing a request with the IRS. A REIT could revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before the due date for filing its tax return.

In addition, the TRA of 1997 conformed the definition of independent contractor for purposes of the foreclosure property rule to the definition of independent contractor for purposes of the general rules.

Payments for Hedging Treated as Qualifying Income - The TRA of 1997 treats income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95% test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) are treated as qualifying income for purposes of the 95% test.

Definition of Excess Noncash Income Expanded - The TRA of 1997: (1) expanded the class of excess noncash items that are not subject to the distribution requirement to include income from the cancellation of indebtedness and (2) extended the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Involuntary Conversions Ignored for Prohibited Sales - The TRA of 1997 excludes from the prohibited sales rules property that was involuntarily converted.

Shared Appreciation Clarified, Bankruptcy Safe Harbor Added - The TRA of 1997 provides that interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within four years of the REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor unless, when the REIT acquired the mortgage, the REIT knew, or had reason to know, that the property subject to the mortgage would be sold in a bankruptcy proceeding.

Qualified REIT Subsidiary Definition Modified - The TRA of 1997 permits any corporation wholly-owned by a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. Where the REIT acquired an existing corporation, any such corporation is treated as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REIT's taxable year.

The provisions conform California to changes made to federal law by the TRA of 1997 as they affect REITs, where applicable, with same effective dates. The provisions did not conform to the federal credit for taxes paid by REIT on retained capital gains because the provision is not applicable. California does impose a separate tax on capital gains retained by REITs. All federal/state differences and exceptions contained in the law prior to the passage of this Act still apply.

**Amend Section 24875.5 of Revenue and Taxation Code** to make technical corrections to financial asset securitization investment trusts (FASITs).

The TRA of 1997 made the following technical amendments to FASITs:

- Requires the "regular interest test" to be met "on or after the startup date" instead of "after the startup date".
- Corrects a cross reference in IRC section 860L(d) from 860L(c)(2) to 860L(b)(2).
- Provides that prohibited transactions rules not apply to foreclosure property or hedges using rules similar to exception applicable to REMICs.

This provision conforms California law to the three federal technical amendments listed above.

**Amend Section 24918 of Revenue and Taxation Code** to correct an incorrect reference. The reference to Section 13226 of Public Law 103-66 is changed to a reference to Section 13150 of that public law.

**Amend Sections 110 and 112 of AB 1040 (Stats. 1997, Ch. 605)** to resolve the discrepancy between Act Sections 110 and 112 of AB 1040. Act Section 110 provided that the amendments made to Section 24411 by AB 1040 applied from the original effective date of the act adding Section 24411 to the Revenue and Taxation Code. However, Section 112 provided that the amendments to Section 24411 would apply to income years beginning on or after January 1, 1998. Section 24411 clarifies that for purposes of the definition of "qualifying dividends" in Section 24411, the term "corporation" would include banks only for income years beginning on or after January 1, 1998.

**Amend Section 30 of SB 455 (Stats. 1997, Ch. 611)** to clarify that SB 455 repealed the Section 17267 relating to Medical Savings Accounts (MSAs). There were two Sections 17267 enacted during 1996; one relating to zones (AB 296, Stats. 1996, Ch. 953) and the other relating to MSAs (SB 38, Stats. 1996, Ch. 954). SB 965 repealed the version enacted by AB 296, relating to zones (the act specifies as enacted by AB 296). SB 455 did not specify that it was repealing Section 17267 as enacted by SB 38; however, SB 455 as amended May 1, 1997, struck out the text of Section 17267 relating to MSAs.

**Add Section 19 to SB 200 (Stats. 1997, Ch. 609)** to remove a duplicate hiring credit provision for the Manufacturing Enhancement Area. SB 200 created the Manufacturing Enhancement Area and contained two hiring credits. The credits are identical except that one is "elected" and the other limits the taxpayer to only one credit for the wages paid. SB 200 was doubled joined to AB 1040 and only one credit was to become operative. The credit that became operative was dependent on whether AB 1040 became law. However, due to a drafting error in SB 200, both credits became operative.

This act will not require any reports by the department to the Legislature.